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Inclusions and Adjustments under Article 9: is further consensus possible?

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In the last few months I have been deeply committed with the Klaus Vogel Lecture, which will be held in September 25, 2015, in the Vienna University of Economics and Business (see invitation here). I have chosen the theme “Arm’s Length beyond the Guidelines of the OECD”. My research has led to the writing of an Article (forthcoming in the IBFD Bulletin for International Taxation). As it is unavoidable upon a scientific research, some issues concerning the current regime of the OECD Model Convention (“OECD-MC”) on transfer pricing or its Guidelines occurred to me but I could not include in the Article, since they were not within the scope of the lecture, They deserve, nevertheless, to be further discussed among scholars. The present article draws on one of such ideas.

When one examines the OECD-MC it is clear to avoid double taxation it is necessary to define which State’s taxation will prevail. In some cases, the residence will exclusively tax. In several cases, there is taxation both in State of source and in State of residence, but in such cases, the OECD-MC provides for that if source taxation occurs according to the OECD-MC rules, the residence State shall respect such priority, and shall either grant a credit, or shall exempt such income. This is furthermore a natural solution: the source State has a first opportunity to tax, and the taxation in residence occurs in a second moment. It is clear, therefore, that the OECD-MC decides which is the “first” State to tax and which State shall observe the “first” State’s taxation. This is true, however, for the traditional conflict source vs. residence. In case of transfer pricing, there is not such conflict; there is no “first” taxation.

Accordingly, due to the wording of Article 9, the application of Arm’s Length Standard (“ALS”) may lead to a double taxation situation. It is possible that one State rejects the inclusion of profits made by the other State due to the application of the ALS under Article 9(1), thus refusing to make the corresponding adjustment under Article 9(2). In such case, the treaty will not achieve its main function, which is to eliminate double taxation.

This outcome is an inherent consequence of applying the ALS under the conditions set forth in Article 9 of the OECD-MC. Whilst the OECD-MC does not present a satisfying solution in case a controversy between States on the pricing of the transactions occurs, it is possible – and not rare – that the contracting parties disagree with respect to inclusions and adjustments.

Such controversy belongs to the very nature of the ALS. The Glossary of the OECD Guidelines even defines the "arm's length range" as "[a] range of figures that are acceptable for establishing whether the conditions of a controlled transaction are arm's length and that are derived either from applying the same transfer pricing method to multiple comparable data or from applying different transfer pricing methods"[1]. The affirmation of an "arm's length range" in place of a single and undisputable arm's length price implies the acknowledgment of a gradual discretion involved in the application of the ALS. In this sense, the German *Bundesfinanzhof* has already stated that there is not one sole comparable price, but rather a range ("*Band*") of them, which leads to the conclusion that also in the market one will find comparable goods or services offered for different prices[2].

In such scenario, it is very likely that contracting States may find different adjustments, all compatible with the ALS. The OECD-MC does not present a solution to this disparity, since it does not answer which should be the State entitled to make the inclusion set forth in Article 9(1). Thus, it is possible that both States apply their own adjustment under Article 9(1), hoping that the other State will apply Article 9(2). Where both States are entitled to make the inclusion, being the other State obliged to make the corresponding adjustment, it is possible that the States do not achieve the same conclusions with respect to which should be the adequate inclusion under Article 9(1), thus refusing to make the respective adjustment under Article 9(2).

In other words, Article 9 takes for granted that one State will apply Article 9(1) and the other State will agree therewith, thus making the corresponding adjustment. If both States simultaneously apply Article 9(1), there is the risk of a disagreement with regard to the inclusion of profits. This is certainly an issue which the OECD-MC has never managed to solve, and is still an open question to any and every ALS-based method.

Indeed, the solution in case a controversy arises should be achieved under a Mutual Agreement Procedure ("MAP") or even by means of an arbitration procedure. Curiously enough, even though such mechanisms may settle the dispute between the States, the outcome of a MAP or of an arbitration procedure is completely contingent: under the current state of art on the interpretation of the OECD-MC, there is no hint on which will be the final result.

It does not seem acceptable, however, from a legal perspective, that the final result of an arbitration cannot be subject to any control. *Arbitration does not imply arbitrary solutions*. It is important to further investigate the theme, in order to find some guidelines to be followed on an arbitration procedure.

The relevant question, therefore, is whether it is possible to find further consensus on the interpretation of Article 9, indicating a solution which should be expected in case an arbitration procedure is initiated. In other words, in case both states insist on their own inclusions, and provided that both inclusions comply with ALS, which one should prevail, i.e., which State should be obliged to recognize the other State's inclusion, applying, therefore, Article 9(2) and making the respective adjustment?

When one considers the conflict source vs. residence, the natural solution is to investigate which is the first State which has the opportunity to tax (i.e.: source) and in case this taxation is according to the treaty, the other State (i.e.: residence) shall observe it. The relevant question, therefore, is whether there is also a "natural" first taxation, i.e., whether one State should be granted priority on making transfer pricing adjustment.

Transfer pricing adjustments are, essentially, an issue of privileging the taxpayers' ability to pay. This is true for both countries of importation and of exportation. In both cases, States adopt measures in order to assure that their taxpayers' ability-to-pay will be measured adequately. No "first" right derives therefrom, since both countries have legitimate expectation under such perspective.

However, when one considers the effect of transfer pricing adjustments, it seems reasonable to argue that the country of importation has a second reason for requiring a transfer pricing adjustment: not only the adjustment assures equal treatment among taxpayers (ability-to-pay), but it is also relevant to assure fair competition within the market of the source State.

One can imagine a situation where several MNEs compete in a very same local market, all of them importing the elements of their products from related companies, located in many jurisdictions. In this case it is clear that, if a controversy arises when determining the transfer price of the imports, and the solution of each residence State where the related companies are located is to be followed, then, *ceteris paribus*, the MNEs will not compete in equal footing in the market of the country of importation. The disparity of pricings carried out by countries of exportation shall, at the end of the day, lead to a situation where the adjustments made by countries of exportation will distort competition in the market of the country of importation.

However, if the adjustment of the country of importation is to be followed, it is possible to neutralize such distortion, as a consequence of submitting all competitors to a very same approach to the pricing of a transaction. The country of importation is the only one able to establish a coherent policy with regard to transfer pricing for competitors within its market. Hence, a comprehensive interpretation of the OECD-MC should lead to the conclusion that, if the States disagree with respect to inclusions and adjustments, the approach of the country of importation should be respected, provided that it is within the ALS range.

Of course, this solution does not aim at tax neutrality, as the difference of rates and the respective ability of states to provide public services and maintain institutions that foster economic activity is certainly the main tax aspect to influence the allocation of assets among States. This is an issue of tax competition, which must be considered apart from the agreements entered by States when signing a tax convention.

Nevertheless, the solution proposed is certainly capable of preventing mere disagreements between States from leading to distortions in the competition between enterprises, thus maintaining the choices made by States when drafting their tax systems, and protecting such choices from unintended distortions. At the same time, it ensures that DTCs accomplish their ultimate intent, which is to avoid double taxation.

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[1] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2010, at 23.

[2] See X. Ditz. Die Grenzen des Fremdvergleichs – Zugleich Plädoyer für ein Festhalten am Fremdvergleichsgrundsatz, *Finanzrundschau* (2015) at 117.

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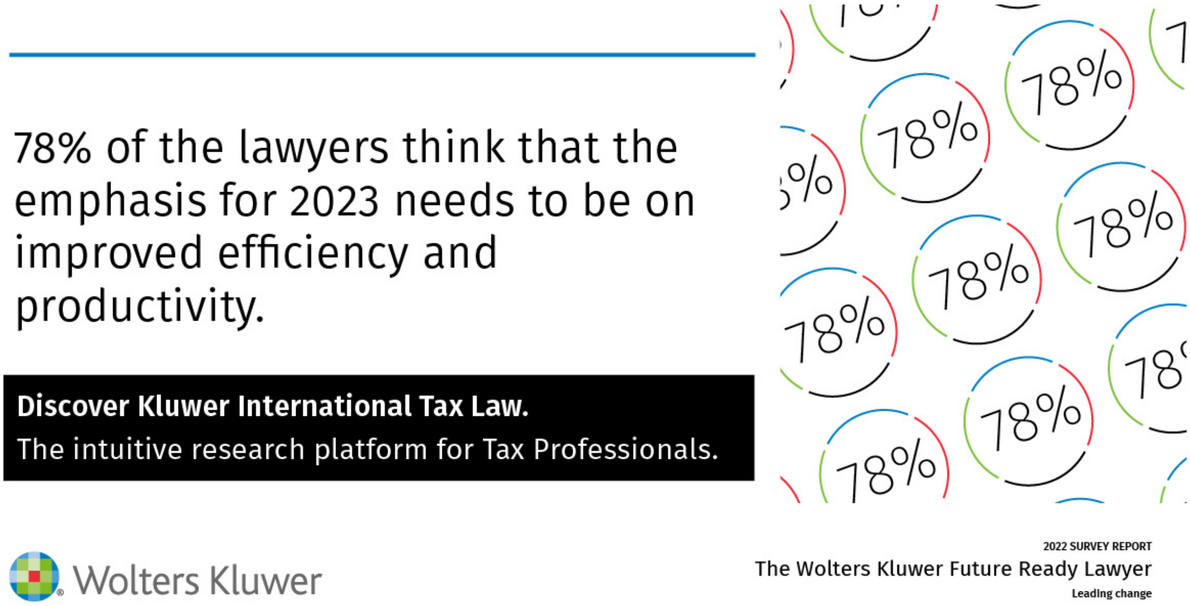

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